

§ 391.5 Qualified withdrawals.

(a) *In general.* (1) A qualified withdrawal is one made from the fund during the taxable year which is in accordance with section 670(f)(1) of the Act, the agreement, and with regulations prescribed by the Secretary of Transportation and which is for the acquisition, construction, or reconstruction of a qualified vessel (as defined in § 391.11(a)(2)) or barges and containers which are part of the complement of a qualified vessel (or shares in such vessels, barges, and containers), or for the payment of the principal of indebtedness incurred in connection with the acquisition, construction, or reconstruction of such qualified vessel (or a barge or container which is part of the complement of a qualified vessel).

(2) For purposes of this section the term *share* is used to reflect an interest in a vessel and means a proprietary interest in a vessel such as, for example, that which results from joint ownership. Accordingly, a share within the meaning of § 391.2(f) (relating to the definition of "agreement vessel" for the purpose of making deposits) will not necessarily be sufficient to be treated as a share within the meaning of this section.

(3) For purposes of this section, the term *acquisition* means any of the following:

(i) Any acquisition, but only to the extent the basis of the property acquired in the hands of the transferee is its cost. Thus, for example, if a party transfers a vessel and \$1 million in an exchange for another vessel which qualifies for nonrecognition of gain or loss under section 1031(a) of the Code (relating to like-kind exchange), there is an acquisition to the extent of \$1 million.

(ii) With respect to a lessee's interest in a vessel, expenditures which result in increasing the amounts with respect to which a deduction for depreciation (or amortization in lieu thereof) is allowable.

(b) *Payments on indebtedness.* Payments on indebtedness may constitute qualified withdrawals only if the party shows to the satisfaction of the Secretary of Transportation a direct connection between incurring the indebtedness and the acquisition, construc-

tion, or reconstruction of a qualified vessel or its complement of barges and containers whether or not the indebtedness is secured by the vessel or its complement of barges and containers. The fact that an indebtedness is secured by an interest in a qualified vessel, barge, or container is insufficient by itself to demonstrate the necessary connection.

(c) *Payments to related persons.* Notwithstanding paragraph (a) of this section, payments from a fund to a person owned or controlled directly or indirectly by the same interests as the party within the meaning of section 482 of the Code and the regulations thereunder are not to be treated as qualified withdrawals unless the party demonstrates to the satisfaction of the Secretary of Transportation that no part of such payment constitutes a dividend, a return of capital, or a contribution to capital under the Code.

(d) *Treatment of fund upon failure to fulfill obligations.* Section 607(f)(2) of the Act provides that if the Secretary of Transportation determines that any substantial obligation under the agreement is not being fulfilled, he may, after notice and opportunity for hearing to the party, treat the entire fund, or any portion thereof, as having been withdrawn as a nonqualified withdrawal. In determining whether a party has breached a substantial obligation under the agreement, the Secretary will consider among other things, (1) the effect of the party's action or omission upon his ability to carry out the purposes of the fund and for which qualified withdrawals are permitted under section 607(f)(1) of the Act, and (2) whether the party has made material misrepresentations in connection with the agreement or has failed to disclose material information. For the income tax treatment of nonqualified withdrawals, see § 391.7.

§ 391.6 Tax treatment of qualified withdrawals.

(a) *In general.* Section 607(g) of the Act and this section provide rules for the income tax treatment of qualified withdrawals including the income tax treatment on the disposition of assets acquired with fund amounts.

(b) *Order of application of qualified withdrawals against accounts.* A qualified withdrawal from a fund shall be treated as being made: First, out of the capital account; second, out of the capital gain account; and third, out of the ordinary income account. Such withdrawals will reduce the balance within a particular account on a first-in-first-out basis, the earliest qualified withdrawals reducing the items within an account in the order in which they were actually deposited or deemed deposited in accordance with this part. The date funds are actually withdrawn from the fund determines the time at which withdrawals are considered to be made.

(c) *Reduction of basis.* (1) If any portion of a qualified withdrawal for the acquisition, construction, or reconstruction of a vessel, barge, or container (or share therein) is made out of the ordinary income account, the basis of such vessel, barge, or container (or share therein) shall be reduced by an amount equal to such portion.

(2) If any portion of a qualified withdrawal for the acquisition, construction or reconstruction of a vessel, barge, or container (or share therein) is made out of the capital gain account, the basis of such vessel, barge, or container (or share therein) shall be reduced by an amount equal to—

(i) Five-eighths of such portion, in the case of a corporation (other than an electing small business corporation, as defined in section 1371 of the Code), or

(ii) One-half of such portion, in the case of any other person.

(3) If any portion of a qualified withdrawal to pay the principal of an indebtedness is made out of the ordinary income account or the capital gain account, then the basis of the vessel, barge, or container (or share therein) with respect to which such indebtedness was incurred is reduced in the manner provided by paragraphs (c) (1) and (2) of this section. If the aggregate amount of such withdrawal from the ordinary income account and capital gain account would cause a basis reduction in excess of the party's basis in such vessel, barge, or container (or share therein), the excess is applied against the basis of other vessels, barges, or containers (or shares therein)

owned by the party at the time of withdrawal in the following order: (i) Vessels, barges, or containers (or shares therein) which were the subject of qualified withdrawals in the order in which they were acquired, constructed, or reconstructed; (ii) agreement vessels (as defined in section 607(k)(3) of the Act and § 391.11(a)(3)) and barges and containers which are part of the complement of an agreement vessel (or shares therein) which were not the subject of qualified withdrawals, in the order in which such vessels, barges, or containers (or shares therein) were acquired by the party; and (iii) other vessels, barges, and containers (or shares therein), in the order in which they were acquired by the party. Any amount of a withdrawal remaining after the application of this paragraph is to be treated as a nonqualified withdrawal. If the indebtedness was incurred to acquire two or more vessels, barges, or containers (or shares therein), then the basis reduction in such vessels, barges, or containers (or shares therein) is to be made pro rata in proportion to the adjusted basis of such vessels, barges, or containers (or shares therein) computed, however, without regard to this section and adjustments under section 1016(a) (2) and (3) of the Code for depreciation or amortization.

(d) *Basis for depreciation.* For purposes of determining the allowance for depreciation under section 167 of the Code in respect of any property which has been acquired, constructed, or reconstructed from qualified withdrawals, the adjusted basis for determining gain on such property is determined after applying paragraph (c) of this section. In the case of reductions in the basis of any property resulting from the application of paragraph (c)(3) of this section, the party may adopt a method of accounting whereby (1) payments shall reduce the basis of the property on the day such payments are actually made, or (2) payments made at any time during the first half of the party's taxable year shall reduce the basis of the property on the first day of the taxable year, and payments made at any time during the second half of the party's taxable year shall reduce the basis of the property on the first day of the

succeeding taxable year. For requirements respecting the change of methods of accounting, see § 1.446-1(e)(3) of the Income Tax Regulations of this chapter.

(e) *Ordinary income treatment of gain from disposition of property acquired with qualified withdrawals.* [Reserved]

§ 391.7 Tax treatment of nonqualified withdrawals.

(a) *In general.* Section 607(h) of the Act provides rules for the tax treatment of nonqualified withdrawals, including rules for adjustments to the various accounts of the fund, the inclusion of amounts in income, and the payment of interest with respect to such amounts.

(b) *Nonqualified withdrawals defined.* Except as provided in section 607 of the Act and § 391.8 (relating to certain corporate reorganizations, changes in partnerships, and transfers by reason of death), any withdrawal from a fund which is not a qualified withdrawal shall be treated as a nonqualified withdrawal which is subject to tax in accordance with section 607(h) of the Act and the provisions of this section. Examples of nonqualified withdrawals are amounts remaining in a fund upon termination of the fund, and withdrawals which are treated as nonqualified withdrawals under section 607(f)(2) of the Act and § 391.5(d) (relating to failure by a party to fulfill substantial obligation under agreement) or under the second sentence of section 607(g)(4) of the Act and § 391.6(c)(3) (relating to payments against indebtedness in excess of basis).

(c) *Order of application of nonqualified withdrawals against deposits.* A nonqualified withdrawal from a fund shall be treated as being made: First, out of the ordinary income account; second, out of the capital gain account; and third, out of the capital account. Such withdrawals will reduce the balance within a particular account on a first-in-first-out basis, the earliest nonqualified withdrawals reducing the items within an account in the order in which they were actually deposited or deemed deposited in accordance with this part. Nonqualified withdrawals for research, development, and design expenses incident to new and advanced

ship design, machinery, and equipment, and any amount treated as a nonqualified withdrawal under the second sentence of section 607(g)(4) of the Act and § 391.6(c)(3), shall be applied against the deposits within a particular account on a last-in-first-out basis. The date funds are actually withdrawn from the fund determines the time at which withdrawals are considered to be made. For special rules concerning the withdrawal of contingent deposits of net proceeds from the installment sale of an agreement vessel, see § 391.2(c)(6).

(d) *Inclusion in income.* (1) Any portion of a nonqualified withdrawal which, under paragraph (c) of this section, is treated as being made out of the ordinary income account is to be included in gross income as an item of ordinary income for the taxable year in which the withdrawal is made.

(2) Any portion of a nonqualified withdrawal which, under paragraph (c) of this section, is treated as being made out of the capital gain account is to be included in income as an item of long-term capital gain recognized during the taxable year in which the withdrawal is made.

(3) For effect upon a party's taxable income of capital losses remaining in a fund upon the termination of a fund (which, under paragraph (b) of this section, is treated as a nonqualified withdrawal of amounts remaining in the fund), see § 391.4(e).

(e) *Interest.* (1) For the period on or before the last date prescribed by law, including extensions thereof, for filing the party's Federal income tax return for the taxable year during which a nonqualified withdrawal is made, no interest shall be payable under section 6601 of the Code in respect of the tax on any item which is included in gross income under paragraph (d) of this section, and no addition to such tax for such period shall be payable under section 6651 of the Code. In lieu of the interest and additions to tax under such sections, simple interest on the amount of the tax attributable to any item included in gross income under paragraph (d) of this section is to be paid at the rate of interest determined for the year of withdrawal under paragraph (e)(2) of this section. Such interest is to be charged for the period from